83-198

No.

In the Supreme Court

OF THE

United States

October Term 1983

Bank of America National Trust and Savings Association
Petitioner,

vs.

Federal Deposit Insurance Corporation,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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QUESTIONS PRESENTED

1. Did the Court of Appeals err in applying a state's "public policy," selected through "choice of law" analysis, to an action this Court has determined is governed by federal common law—an action by the Federal Deposit Insurance Corporation ("FDIC") in its corporate capacity arising out of the insolvency of a state bank?

2. Should the line of federal decisions upholding creditors' setoffs against insolvent banks and setoffs against subordinated debt determine the rights of the FDIC as the successor in interest of an insolvent state bank?

3. Can a Court of Appeals properly substitute its own view of a state's public policy for that of the state official charged with determining that policy, and then invalidate a contract expressly approved by the state official, on the ground that the contract conflicts with the Court's view of the state's public policy?

4. When a national bank makes a subordinated loan to a state bank in reliance on a written contract that expressly preserves the national bank's right of setoff and provides that the rights under the contract are governed by the law of the national bank's domicile allowing setoff, and the Secretary of the Treasury who regulates the state bank approves the contract, does federal common law require that the setoff provision be voided on the theory that the setoff is contrary to the "public policy" of the domicile of the insolvent state bank?

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Petitioner Bank of America National Trust and Savings Association ("Bank of America") respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit entered in this proceeding on March 18, 1983.

OPINION BELOW

The opinion of the Court of Appeals is reported at 701 F.2d 831 and is reproduced in Appendix A, at A-1-20. No written opinion was rendered by the District Court. The transcript of the July 17, 1981 hearing at which the District Court made its findings and conclusions of law in favor of Petitioner appears in Appendix B, at A-21-48.

JURISDICTION

The judgment of the Court of Appeals for the Ninth Circuit was entered on March 18, 1983. A timely petition for rehearing or for rehearing *en banc* was denied on May 6, 1983 (App. C, at A-49). This petition for certiorari was filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

The federal statutes involved are 12 U.S.C. §§ 1819 (Fourth) and 1823(e) (1976) (App. D, at A-50). The California statutes involved are California Code of Civil Procedure § 431.70 (1973) and California Commercial Code § 4102(2) (1964) (App. E, at A-51). The Virgin Islands statutes involved at V.I. Code Ann. tit. I, § 4 (1967), and V.I. Code Ann. tit. IIA, § 4-102(2) (1965) (App. F, at A-52). The Puerto Rican provisions are P.R. Laws Ann. tit. 7, § 111(o) (1981), and Regulation No. 4 promulgated by the Secretary of the Treasury of Puerto Rico (App. G, at A-53-55).

STATEMENT OF THE CASE

On December 27, 1973, four national banks, led by Bank of America, entered into a Note Purchase Agreement with Banco Credito y Ahorro Ponceño ("Banco Credito"), a Puerto Rican banking corporation. Collectively, the four banks agreed to lend Banco Credito ten million dollars.[1]

[1]The four lending banks and the amounts of their loans were:

Bank of America	\$5,000,000
Continental Illinois	3,000,000
Seattle-First National	1,000,000
Wells Fargo	1,000,000

Bank of America N.T. & S.A. is a subsidiary of BankAmerica Corp.

The Agreement provided that Banco Credito's debt to the lending banks was to be subordinated to certain other debts incurred by Banco Credito. The Agreement also stated that so long as Banco Credito was subject to Regulation No. 4 of the Secretary of the Treasury of Puerto Rico, the Secretary could "suspend" Banco Credito's payment of principal or interest whenever payment might, in his judgment, "affect the financial solvency" of Banco Credito. The subordination and suspension provisions were required by Puerto Rican law if Banco Credito and the Secretary were to treat the loans as "subordinated capital notes."

Section 7.6 of the Agreement stated:

> Nothing in this Agreement shall be deemed any waiver or prohibition of [Bank of America's] right of banker's lien or setoff.

Section 7.7 of the Agreement provided that the Agreement and the Capital Notes issued pursuant thereto would "be deemed to be under the laws of the State of California." The Secretary of the Treasury of Puerto Rico, after making several substantive changes in the draft Agreement and underlying notes, approved the language of the Note Purchase Agreement.[2]

On June 24, 1977, the Secretary of the Treasury of Puerto Rico ordered Banco Credito to suspend payment on its note to Bank of America, and on March 31, 1978, he declared Banco Credito insolvent and closed the bank. As of that date, Banco Credito owed Bank of America

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[2]The FDIC also authorized the issuance of the Capital Notes, but the record does not reflect whether the FDIC reviewed the express contractual language allowing setoff.

$3,250,125.60 in unpaid principal and interest. On that same day, Bank of America set off the balances of three demand deposit accounts Banco Credito maintained with Bank of America's branches in the Virgin Islands and California.[3] This setoff reduced Banco Credito's outstanding debt by $903,589.15. On April 11, 1981, Bank of America set off an additional $78,609.46 from Banco Credito accounts in San Francisco and the Virgin Islands, for a total setoff of $982,198.61. These setoffs left Banco Credito indebted to Bank of America in an amount in excess of $2,250,000, a sum that Bank of America will never recover.

The FDIC acquired Banco Credito's claim to the Bank of America deposits following a "purchase and assumption" agreement in which other Puerto Rican banks assumed all of Banco Credito's liabilities. *See* 12 U.S.C. § 1823(e) (1976). No depositor or unsubordinated creditor of Banco Credito lost a dime due to Banco Credito's failure.

On March 28, 1980, the FDIC sued Bank of America to recover the deposits in Bank of America's California and Virgin Islands branches, claiming that the setoffs violated the contracts of deposit or constituted conversion.[4] Bank of America argued that federal common law (as well as the laws of California and the Virgin Islands, where the deposits were set off) allowed the setoffs, expressly relying on an unbroken string of federal decisions holding that the debts of insolvent banks and subordinated debts are sub-

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[3]The account balances set off were as follows:

San Francisco	$ 97,713.39
St. Croix, Virgin Islands	322,363.27
St. Thomas, Virgin Islands	483,512.49
	$903,589.15

[4]Federal jurisdiction was originally invoked under 12 U.S.C. § 1819 (Fourth) (1976).

ject to setoff. Furthermore, Bank of America contended that Section 7.6 of the Agreement, approved by the Secretary of the Treasury of Puerto Rico, expressly guaranteed Bank of America's right of setoff.

The District Court held that the Agreement unambiguously preserved Bank of America's right of setoff, that the contractual provision guaranteeing setoff was not illegal, and that Bank of America was entitled to its contractual bargain. The Court of Appeals reversed. The appellate court, purporting to apply "federal common law," instead applied a "choice of law" analysis, substituted Puerto Rican law for the parties' contractual choice of California law, and held that Puerto Rican "public policy" barred the setoff.

The court distinguished or ignored the decisions applying federal common law which hold that subordinated debts are subject to setoff. As for Bank of America's express contractual guarantee of setoff, the Court of Appeals held, despite the Puerto Rican banking regulator's express approval of the contractual setoff guarantee, that the setoff provision was contrary to Puerto Rican "public policy" and therefore void.

REASONS FOR GRANTING THE WRIT

The holding below conflicts with the decisions of this Court and with other Court of Appeals and District Court decisions in two areas: (1) the decision fails to apply established and uniform federal common law principles, and instead applies a "choice of law" analysis in selecting Puerto Rican "public policy" as the governing law in a suit by the FDIC; and (2) the decision holds that a subordinated obligation is not subject to setoff. In addition, the

opinion below improperly treats national bank subordinated lenders as though they were the shareholders and insurers of state banks, a role Congress intended the FDIC to fill. Finally, the decision erroneously voids a contractual guarantee of setoff expressly approved by the Secretary of the Treasury of Puerto Rico, the official charged with administering Puerto Rican banking "public policy," on the theory that the contract violates Puerto Rico's "public policy" and that the Secretary's approval was therefore *ultra vires*.

The Court of Appeals' determination that the FDIC's rights are not subject to uniform established federal rules, that subordinated debts are not subject to setoff, and that a lending bank cannot rely on a written contract approved by state banking authorities preserving its right of setoff, threatens to disrupt a significant method of inter-bank financing. By substituting the uncertainties of varying state "public policies" for uniform federal common law, and by voiding a national bank's express contractual guarantee of setoff, the decision below will make it extremely difficult for state banks to obtain the new financing many of them urgently require. These erroneous holdings require correction by this Court.

I. THE NINTH CIRCUIT'S DECISION CONFLICTS WITH ESTABLISHED PRINCIPLES OF FEDERAL COMMON LAW AND INTRODUCES UNCERTAINTY INTO THE BANK FINANCING SYSTEM

A. The Rights of the FDIC Must Be Determined By Uniform Federal Principles, Not By the "Public Policies" of the Various States

The Court of Appeals' application of Puerto Rican "public policy" conflicts with 12 U.S.C. § 1819 (Fourth), and with *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447,

456 (1942), which require the application of federal common law in a case involving the rights of the FDIC in its corporate capacity. In his concurring opinion in *D'Oench*, Justice Jackson noted:

> That a particular state happened to have the greatest connection, in the conflict of laws sense, with the making of the note involved, or that the subsequent conduct happened to be chiefly centered there, is not enough to make us subservient to the legislative policy or the judicial views of that state.

315 U.S. at 473 (Jackson, J. concurring). *Accord, FDIC v. Meo*, 505 F.2d 790, 793 n.4 (9th Cir. 1974). *See also United States v. Yazell*, 382 U.S. 341, 354 (1966) (federal "bank deposit insurance program is general and standardized," and requires uniform federal policies).

The Eleventh Circuit, in *Gunter v. Hutcheson*, 674 F.2d 862, 867-73 (11th Cir. 1982) *cert. denied*, 103 S. Ct. 60 (1982), recently reemphasized the need to apply uniform federal common law principles, not state law, in a suit involving the rights of the FDIC in a "purchase and assumption" transaction involving an insolvent state bank. *Gunter* holds that under federal law the right of the FDIC to collect on a note acquired, as here, in a purchase and assumption transaction, is determined solely by the written records of the insolvent bank, and cannot be affected by contrary state policies or state rules of decision. *Id.* at 868-73.

The Ninth Circuit's application of Puerto Rican "public policy"[5] injects uncertainties and inconsistencies into the

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[5]In a full briefing on the merits, Petitioner will show that Puerto Rican law neither attempts to control nor could control setoffs effected by a national bank in other jurisdictions that allow setoff. To the extent state law has any bearing on the determination of

national bank financing and insurance systems, in violation of 12 U.S.C. § 1819 (Fourth), *D'Oench*, *Yazell*, and *Gunter*. The inconsistencies and conflicts with federal law caused by the Ninth Circuit's application of state law are real, not theoretical, as Petitioner will demonstrate *infra*.

B. The Ninth Circuit's Decision Conflicts With Federal Cases Holding That Federal Common Law Allows Set-off of Subordinated Debts

The Ninth Circuit's decision below conflicts with *Rochelle v. United States*, 521 F.2d 844 (5th Cir. 1975), *modified on other grounds*, 526 F.2d 405 (1976), *cert. denied*, 426 U.S. 948 (1976); *Hayden v. Standard Accident Insurance Co.*, 316 F.2d 598 (9th Cir. 1963); and *Allegaert v. Perot*, 466 F. Supp. 516 (S.D.N.Y. 1978). Each of these cases applied federal common law in concluding that subordinated obligations, whether subordinated by law or by contract, are subject to setoff. In *Rochelle*, the court of appeals allowed the United States to set off its obligation to pay a tax refund against a claim owed to the United States that was statutorily subordinated under former 11 U.S.C. § 23g. In describing the relationship between setoff and subordination, the court held:

> We think a subordinated claim can be used to set off a claim by the bankrupt estate against the creditor even

federal common law, it should be the substantive law "with reference to which the makers and the insured bank presumably contracted," *D'Oench*, 315 U.S. at 474. In this case, the parties to the contract chose California law, which provides that an action for non-payment is governed by the law of the place where the bank deposit is located. Cal. Com. Code § 4102(2). *Accord, Restatement (Second) of Conflict of Laws* (1971), § 196 comment d. California law provides for the automatic extinction of cross-demands for debts owed. Cal. Civ. Proc. Code § 431.70. Virgin Islands law is in accord. V.I. Code Ann. tit. IIA, § 4-102(2); V.I. Code Ann. tit. I, § 4.

> though the subordinated claim could not itself share in the dividends. And we think this rule is applicable where the claim is subordinated by operation of [statute].

Rochelle v. United States, 521 F.2d at 855.

The *Hayden* case likewise interprets the federal doctrine of setoff to allow setoff of statutorily subordinated claims. 316 F.2d at 602. *Allegaert v. Perot*, relying on *Rochelle* and *Hayden*, holds that contractually subordinated debts are subject to setoff. 466 F. Supp. at 519.

Although *Rochelle, Hayden* and *Allegaert* all discussed setoffs in the context of section 68 of the former Bankruptcy Act, their holdings express general federal common law principles. This Court has repeatedly held that section 68 of the Bankruptcy Act did not create or expand upon the traditional right of setoff, but merely allowed those federal common law principles to be enforced in bankruptcy cases.[6] *See, e.g. Cumberland Glass Co. v. DeWitt*, 237 U.S. 447, 455 (1914); *Studley v. Boylston National Bank*, 229 U.S. 523, 528 (1913) (allowing bank to set off an insolvent's deposits); *Scott v. Armstrong*, 146 U.S. 499, 511 (1892) (upholding bank's setoff as defense to suit by receiver of a national bank). These cases reject the argument that a setoff is a preference or payment; the assets of an insolvent

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[6]The Court of Appeals for the Second Circuit recently reemphasized the longstanding reliance that banks have placed on the doctrine of setoff:

> The rule allowing setoff, both before and after bankruptcy, is not one that courts are free to ignore when they think application would be "unjust." It is a rule that has been embodied in every bankruptcy act the nation has had, and creditors, particularly banks, have long acted in reliance upon it.

In re Applied Logic Corp., 576 F.2d 952, 957-58 (2d Cir. 1978) (footnote omitted).

bank are limited to the funds available *after* offset. *Accord, FDIC v. Mademoiselle of California,* 379 F.2d 660, 663 (9th Cir. 1967); *State v. Brobston,* 94 Ga. 95, 21 S.E. 146 (1894).

C. The Result Below Is in Direct Conflict With a Federal Decision Involving Identical Issues and Facts

The legal inconsistencies created by the Ninth Circuit's application of state law are best exemplified by contrasting the decision below with *FDIC v. Louisiana National Bank,* 653 F.2d 927, 930 (1981). In *Louisiana National Bank,* the trial court held that, even in the absence of a contractual right of setoff, a lending bank could, as a matter of federal common law, set off deposits against an insolvent bank's capital note "subordinated in right of payment" to all other indebtedness.[7] The identical issue is presented in this case, except that Bank of America also had a contractually guaranteed right of setoff. The anomaly of denying Bank of America its right of setoff while granting it to the Louisiana National Bank is precisely the inconsistency that uniform federal rules are designed to prevent.

D. The Application of State "Public Policy" Rather Than Uniform Federal Law Allows the FDIC to Adopt Inconsistent Legal Arguments and Policies

The FDIC has recently relied on the federal common law cases discussed in Section B, *supra,* in arguing that setoffs should not be treated as payments, but rather as a "mere

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[7]In *FDIC v. La. Nat'l Bank,* the question of whether federal law allowed setoffs against subordinated debts was the "principal contested issue" during the early stages of the case. The FDIC chose not to appeal from summary judgment on that issue. The Fifth Circuit therefore decided only that the insolvent bank was in default, and upheld the setoff. 635 F.2d at 930-31.

shifting of credits" that does not augment the assets of the party effecting the setoff. In *Chase Manhattan Bank, N.A. v. Federal Deposit Insurance Corp.*, 554 F. Supp. 251 (W.D. Okla. 1983), the FDIC, as receiver for the insolvent Penn Square Bank, set off funds on deposit with Penn Square against loans the depositors owed to Penn Square in which Chase had purchased substantial participations. When Chase requested its pro rata share of the offsets and a description of the loans against which the deposits were set off, the FDIC refused to comply.

The district court upheld the FDIC's position, holding that even if Chase had a preferred claim, it was not entitled to funds from the offsets because

> an offset is not a payment but merely a setting-off against the loan of previously established credits. [...] An offset is a bookkeeping transaction or a "mere shifting of credits." By its very nature an offset cannot augment the receiver's estate.

554 F. Supp. at 254. The district court further observed, adopting the FDIC's view of setoff:

> By way of offsetting the deposits against indebtedness to Penn Square Bank, the FDIC is receiving no "funds" but is merely carrying out "paper transactions" which constitute "a mere shifting of credits." In short, there is no *res* to which Chase's claim as a preferred creditor can attach.

554 F. Supp. at 257. The same analysis here would compel the conclusion that Bank of America has not received a "payment" or "funds" in violation of any statutory subordination requirement, and that its "paper transaction" in setting off Banco Credito's deposits provides no fund that the FDIC could claim as an unsubordinated creditor.

The FDIC apparently chooses to blow hot and cold on what a setoff is, or whether it matters what type of loan a deposit is set off against, depending upon whether or not the setoff is of financial benefit to the FDIC. This is hardly the uniform federal system envisioned by Congress and this Court, and it is the Ninth Circuit's failure to apply established federal rules that has allowed the FDIC successfully to assert diametrically opposed legal arguments.

E. The Decision Below Conflicts With the Congressional Purpose in Creating the FDIC

The decision below also erroneously holds that subordinated lenders should be treated as the creators of a "trust fund" for the benefit of unsubordinated creditors and the FDIC. Before the creation of the FDIC, the only insurance for creditors in bank insolvencies was a statutory assessment against the insolvent bank's shareholders. Former 12 U.S.C. § 63 (repealed 1959). After the FDIC was created for the purpose of insuring against bank failures, Congress eliminated any special liability of bank shareholders to bank depositors, since the FDIC provided the safety net for all bank creditors. 12 U.S.C. § 64a (as amended by Act of May 18, 1953, Pub. L. No. 28, 1953 U.S. Code Cong. & Ad. News (67 Stat. 27) 36); *see also* 1953 U.S. Code Cong. & Ad. News at 1642-43.

The opinion below turns the current federal statutory scheme on its head, treating subordinated creditors like stockholders and requiring them to act as insurers for the FDIC. Besides conflicting with the Congressional purpose in creating the FDIC, this aspect of the decision is contrary to numerous cases holding that creditors may not be treated like shareholders.[8] This Court should resolve these impor-

[8]*See Consolidated Rock Co. v. Du Bois,* 312 U.S. 510, 527 (1941) (creditors entitled to "absolute priority" over stockholders in reor-

tant legal issues concerning the proper role of the FDIC in bank insolvencies.

F. The Ninth Circuit's Introduction of Uncertainties Into the Bank Financing System Will Impair the Ability of Smaller Banks to Obtain Needed Financing

As discussed above, the Ninth Circuit's decision departs from uniform traditional principles of federal common law and introduces uncertainties and inconsistencies into the bank financing and insurance systems. Moreover, its voiding of a contractual provision expressly approved by a state bank regulator undermines the ability of lenders, creditors and state banking officials to limit the new uncertainties by agreement and contract.

Uncertainty in the legal framework governing the rights of lenders in inter-bank financings will inevitably increase the cost and decrease the availability of new financing for state banks. It is for this reason, as well as the need for uniform laws to govern the FDIC, that the courts have applied federal common law in cases such as this one. To allow a panel of the Ninth Circuit to upset that uniform system will have adverse consequences radiating far beyond the parties to this action. This result is particularly unfortunate at a time of national concern over the solvency of smaller banking institutions. This Court should therefore

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ganization); *Case v. Los Angeles Lumber Co.*, 308 U.S. 106, 116-131 (1939) ("fair and equitable" reorganization often requires complete exclusion of stockholders; creditors get "absolute priority," not "relative priority"); *Klapmeier v. Flagg*, 677 F.2d 781, 784 (9th Cir. 1982) (to treat convertible debentures as if they were unpaid stock subscriptions, and therefore disallow a setoff, "would violate the fundamental distinction between corporate shareholders and creditors"); *Pettibone v. Toledo*, 148 Mass. 411, 19 N.E. 337-339 (1889).

grant the petition and correct the Ninth Circuit's clearly erroneous decision.

II. THE COURT OF APPEALS ERRED IN SUBSTITUTING ITS VIEW OF PUERTO RICAN PUBLIC POLICY FOR THAT OF THE SECRETARY OF THE TREASURY OF PUERTO RICO, AND IN VOIDING BANK OF AMERICA'S CONTRACTUAL GUARANTEE OF SETOFF

It is an axiom of federal common law that the courts should give great deference to the actions of administrators charged with enforcing a regulatory scheme. *Blum v. Bacon*, 457 U.S. 132, 141 (1982). Although its decision purports to apply Puerto Rican public policy, the Court of Appeals in fact disregarded and invalidated the actions of the official charged with interpreting Puerto Rican banking policy.

The Secretary of the Treasury of Puerto Rico approved the contract that guaranteed Bank of America's right of setoff. The District Court stated that "obviously the Bank was not going to enter into this Agreement unless it was entitled to setoff." App. B. at A-35.

The Secretary of the Treasury concluded that it promoted Puerto Rican public policy to induce Bank of America to lend $5 million to Banco Credito, even though part of the consideration for the loan was the preservation of Bank of America's right of setoff.[9] As the Court of Appeals

[9]As the District Court below properly held, nothing in the Puerto Rican statutes suggests that a contract allowing setoffs of bank deposits in other states would be illegal. Indeed, in briefing on the merits, petitioner will demonstrate that the Puerto Rican law concerning subordinated capital notes regulates only the conduct of Puerto Rican banks and the Puerto Rican Secretary of the Treasury regarding the classification of certain assets and liabilities. *See* P.R. Laws Ann. tit. 7 § 111(o) (1981) and P.R. Treas. Reg. No. 4 in Appendix G.

admitted (App. A, at A-19), nothing in the Puerto Rican statutes provides that setoffs effected by a national bank against deposits maintained outside of Puerto Rico either should or could be prohibited.

The Ninth Circuit disregarded the Secretary's approval, holding that the setoff provision was void as contrary to Puerto Rican public policy, even though the subordination provision had already been enforced to the extent of Bank of America's $2.25 million loss. The Court of Appeals in effect rewrote Bank of America's bargain, enforcing the subordination provision, but not the setoff clause that served as part of the consideration for the subordinated loan.

In rewriting Bank of America's contract, the Court of Appeals cited no authority, and ignored the rule that federal courts are "reluctant to nullify a contract which has been executed." *Occidental Life Insurance Co. v. Pat Ryan & Associates, Inc.*, 496 F.2d 1255, 1267 (4th Cir. 1974), *cert. denied*, 419 U.S. 1023 (1974). Where, as here, a party has advanced funds in reliance on a contract, it is proper to require return of the funds advanced as a condition of voiding the contract, even if the contract is void under an express statute. *See Parkersburg v. Brown*, 106 U.S. 487, 503 (1883); *George Foreman Associates, Ltd. v. Foreman*, 389 F. Supp. 1308, 1316 (N.D. Cal. 1974), *aff'd*, 517 F.2d 354 (9th Cir. 1975); *City of Florence v. Anderson*, 95 F.2d 777, 779 (4th Cir. 1938).

The approach adopted by the Court of Appeals requires Bank of America to suffer an unbargained-for loss of an additional million dollars simply because it relied on the Puerto Rico Treasury Secretary's interpretation of his own regulation. The FDIC, which by law has no greater

rights than Banco Credito and is supposed to be the ultimate insurer of the banking system, is the beneficiary of this "bait and switch" public policy. Even if Puerto Rican law did control this case, and even if the Secretary misrepresented that law, the FDIC should be estopped from taking advantage of that misrepresentation. *United States v. Lazy FC Ranch*, 481 F.2d 985, 990 (9th Cir. 1973) (where party contracts in detrimental reliance on government assurance that contract complies with public policy, government estopped to deny benefit of bargain). *Accord, Akbarin v. Immigration and Naturalization Service*, 669 F.2d 839, 843 (1st Cir. 1982); *Laguna Hermosa Corp. v. Martin*, 643 F.2d 1376, 1379-80 (9th Cir. 1981) (U.S. Bureau of Reclamation required to extend concession agreement where concessionaire built facilities on county's assurances that agreement would be extended); *Walsonavich v. United States*, 335 F.2d 96, 101 (3d Cir. 1964).

To allow the FDIC to benefit from the Secretary's misrepresentation conflicts not only with the foregoing cases, but also with the Congressional intent expressed in 12 U.S.C. § 1823(e) and this Court's decision in *D'Oench*. Section 1823(e) provides that agreements that tend to diminish the FDIC's right to any asset of an insolvent bank must be a written official record of the insolvent bank, properly approved and executed by its board of directors. As this Court held in *D'Oench*, federal policy is designed to protect the FDIC from a "scheme of deception" or "secret agreements." 315 U.S. at 458. Federal law was not intended to penalize a bank lender for entering into a good-faith, governmentally approved contract. If the holding below stands, the parties "deceived" will be not only

Bank of America and the other lending banks, but also all inter-bank subordinated lenders who have relied on the longstanding doctrine of setoff and on the sanctity of written contracts. The Ninth Circuit's voiding of Bank of America's express contractual right of setoff, like its failure to apply federal common law, introduces uncertainty in bank financing to the detriment of both lending banks and banks seeking new financing.

CONCLUSION

For all the reasons set forth in this Petition, Bank of America requests that a Writ of Certiorari be granted to correct a decision that contravenes federal law and creates conflicts and inconsistencies in the bank financing and federal deposit insurance systems.

Respectfully submitted,

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Appendix A

Federal Deposit Insurance Corporation,
Plaintiff-Appellant,

v.

Bank of America National Trust and Savings
Association, Defendant-Appellee.

No. 81-4590.

United States Court of Appeals,
Ninth Circuit.

Argued Sept. 15, 1982.
Reargued and Submitted Dec. 16, 1982.
Decided March 18, 1983.

Before Duniway, Pregerson and Boochever,
Circuit Judges.

Duniway, Circuit Judge:

The Federal Deposit Insurance Corporation (FDIC) appeals from a summary judgment in favor of Bank of America, N.T.&S.A., in an action by FDIC to recover moneys deposited with Bank of America by Banco Credito y Ahorro Ponceno, a Puerto Rican Bank (Banco Credito) which became insolvent. Bank of America offset its liability for the deposits against the unpaid balance owed to it on a $5,000,000 subordinated capital note issued by Banco Credito. The trial court upheld the setoff. We reverse.

I. *The Facts.*

Banco Credito was organized under the laws of Puerto Rico and regulated by the Puerto Rican Secretary of the Treasury. The depositors of Banco Credito were insured

by FDIC. In 1973 Banco Credito received permission from the Secretary to issue subordinated capital notes, and on December 27, 1973, Banco Credito and Bank of America entered into a note purchase agreement. Puerto Rican law provides, in pertinent part:

> Such capital notes shall be subject in right to the obligations with the depositors and other creditors of the issuing bank. . . . The Secretary of the Treasury may suspend the payment of the principal of and interest on capital notes on or before they fall due, when such payment may reduce the aggregate total amount of the capital stock, reserve fund and capital notes, and when in his judgment such payment may affect the economic solvency of the bank and endanger the interests of the depositors and of the public in general.
>
> (P.R. Laws Ann., Tit 7, § 111*(o)*)

The note purchase agreement included these provisions and provided for a $5,000,000 capital note to be issued to Bank of America. The agreement also included the following provision: "Nothing in this agreement shall be deemed any waiver or prohibition of BANKS' [Bank of America's] right of banker's lien or setoff." (§ 7.6) Pursuant to Regulation No. 4 of the Puerto Rican Secretary of the Treasury, the agreement was submitted to the Secretary for his approval. He approved the agreement without questioning the inclusion of the setoff provision, and on December 28, 1973, Banco Credito executed a $5,000,000 subordinated capital note in favor of Bank of America which stated its subordinated character and the Secretary's right to suspend payments. Although the note did not include a setoff provision, it incorporated the terms of the note purchase agreement

by reference. The note was to be repaid over a seven-year period ending on December 28, 1980.

Banco Credito made timely payments of principal and interest through June 24, 1977. On that day, the Secretary, acting under authority of P.R. Laws Ann., Tit. 7, § 111*(o)* and his Regulation No. 4, determined that continued payment of the note would affect the solvency of Banco Credito and suspended Banco Credito's obligation to make payments of principal and interest on the note. The Secretary's order was never revoked and no further payments were made on the note. At the time of the suspension Banco Credito owed Bank of America a balance of approximately $3,250,000 on the note.

On March 31, 1978, the Secretary determined that Banco Credito was not in sufficiently sound financial condition to continue its operations and was insolvent. Acting pursuant to P.R. Laws Ann., Tit. 7, § 201, the Secretary assumed control of Banco Credito and appointed FDIC as receiver of Banco Credito for the purpose of its total liquidation.

Among the assets of Banco Credito on March 31, 1978 was approximately $1,000,000 on deposit at Bank of America branches in San Francisco, California, and St. Croix and St. Thomas, Virgin Islands. These deposit accounts apparently pre-existed the note purchase agreement. Upon discovering that Banco Credito was insolvent and in receivership, Bank of America promptly set off $903,589.15 of the demand deposit accounts as a credit against Banco Credito's outstanding debt on the subordinated capital note. Approximately three years later Bank of America set off an additional $78,609.46 from the same Banco Credito

accounts. The setoffs left Banco Credito indebted to Bank of America on the capital note in an amount of approximately $2,250,000, none of which has been paid.

After its appointment as receiver, FDIC embarked upon the liquidation of Banco Credito by a "purchase and assumption" agreement with another Puerto Rican bank under which the assuming bank assumes the insolvent bank's liabilities as consideration for transfer of the insolvent bank's marketable assets. The assuming bank was entitled to return to FDIC as receiver any uncollectible receivables of the insolvent bank. When Bank of America claimed setoff and refused to honor the assuming bank's demand for the amounts on deposit, the uncollectible obligation was reassigned to the FDIC as receiver, and it, in turn, sold the deposit obligation to the FDIC in its corporate capacity.

FDIC, in its corporate capacity, brought this action against Bank of America in the United States district court in San Francisco alleging breach of contract and conversion by Bank of America in refusing to honor the deposit obligation. Bank of America defended the claims on the ground that it had properly set off the deposit balances against the obligation of Banco Credito to it on the subordinated note.

The parties made cross-motions for summary judgment at the invitation of the court. The court granted summary judgment for Bank of America on the ground that the right of setoff was explicitly preserved in the note purchase agreement which had been approved by the Puerto Rican Secretary of the Treasury.

FDIC moved for a new trial on the ground that it had discovered new evidence. The court denied the motion. FDIC now appeals from both the summary judgment and the denial of its motion for a new trial.

II. *The Applicable Law.*

Where, as here, the FDIC is proceeding in its corporate capacity, federal law applies. *D'Oench, Duhme & Co. v. F.D.I.C.*, 1942, 315 U.S. 447, 455-456, 467-468, 62 S.Ct. 676, 678-79, 683-84, 86 L.Ed. 956 (Jackson, J., concurring). The Federal Deposit Insurance Act, 12 U.S.C. ch. 16, provides, in § 1819 Fourth, that "All suits of a civil nature at common law or in equity to which the [Federal Deposit Insurance] Corporation shall be a party shall be deemed to arise under the law of the United States, . . ." There is an exception, not applicable here, for cases in which FDIC is acting "in its capacity as receiver of a State bank." *D'Oench, supra*, applies a similar provision in former 12 U.S.C. § 264(j) Fourth.

The parties have not called to our attention any Federal decisions, or for that matter, any California or Puerto Rico decision, or any decision of any other jurisdiction, dealing with the precise issue before us: whether a bank that holds a subordinated capital note of a Puerto Rican bank and has on deposit funds of the Puerto Rican bank should be permitted to set off the deposited funds against the indebtedness of the Puerto Rican bank on the subordinated note. Nor have the parties brought to our attention any federal statute dealing with that question. Under these circumstances, we "are free to apply the traditional common law technique of decision and draw upon all the sources of the common law in cases such as the present."

Federal Deposit Ins. Corp. v. Meo, 9 Cir., 1974, 505 F.2d 790, 793, n. 4, quoting from *D'Oench, supra*, 315 U.S. at 472, 62 S.Ct. at 686 (Jackson, J., concurring).

What, then, should we look to as the federal law? The note purchase agreement says, in § 7.7, "the law of California." Courts generally have held, and this court specifically has held, that parties may agree as to the law to be applied to their contract. *See* Restatement, Conflict of Laws 2d., § 187; *North River Ins. Co. v. Fed Sea/Fed Pac Line*, 9 Cir., 1981, 647 F.2d 985, 987. The transaction has certain California features. Payment was to be made in California, Bank of America's head office is in California, and the setoff was accomplished in part in California and in part in the Virgin Islands. This action was brought by FDIC in a federal court in California.

On the other hand, Banco Credito was a Puerto Rican bank, organized and regulated by Puerto Rican law, and doing business in Puerto Rico. The note purchase agreement was made subordinate pursuant to Puerto Rican law, and the subordination provision is for the protection of the depositors and other creditors of Banco Credito. The power of the Secretary in Puerto Rico to suspend payments on the note exists under Puerto Rican law and is to be exercised for the benefit of those creditors. The objective was to put those creditors ahead of the holders of the subordinated notes, such as Bank of America. A broader objective of the law was to help to maintain the solvency of Puerto Rican banks, and the public confidence in them, conditions important to the viability and prosperity of the Puerto Rican economy. All of these considerations point to the law of Puerto Rico, and the provisions

of that law and of Puerto Rican Regulation 4 are incorporated, almost verbatim, in the capital note and the note purchase agreement. Those provisions bear directly on the question that we must decide.

Section 187(2) of the Restatement provides that the law of the state chosen by the parties to a contract will be applied unless:

> (b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.
>
> Comment g to § 187 states, in part: The chosen law should not be applied without regard for the interests of the state which would be the state of the applicable law with respect to the particular issue involved in the absence of an effective choice of the parties. . . . Application of the chosen law will be refused only (1) to protect a fundamental policy of the state which, under the rule of § 188, would be the state of the otherwise applicable law, provided (2) that this state has a materially greater interest than the state of the chosen law in the determination of the particular issue.
>
> • • •
>
> No detailed statement can be made of the situations where a "fundamental" policy of the state of the otherwise applicable law will be found to exist.
>
> • • •
>
> To be "fundamental," a policy must in any event be a substantial one.

We hold that the provisions of Puerto Rican law and regulations governing the issuance and subordination of

the capital notes of Puerto Rican banks are "fundamental," and we therefore look to that law for the resolution of the issue that is before us.

III. *The Claimed Right of Setoff.*

A.

We first consider whether, if the note purchase agreement did not contain the provision against waiver or prohibition of Bank of America's "right of banker's lien or setoff," Bank of America could have set off the deposits against the subordinated note. We conclude that it could not.

The law of Puerto Rico which we have quoted expressly provides for the subordination of the capital note, and makes it clear that this is for the protection of the depositors and creditors of Banco Credito. Regulation No. 4 of the Secretary of the Treasury of Puerto Rico makes this purpose even more explicit. It requires that the Secretary "take into consideration the capital needs of the bank, its financial condition and if the said issuance of capital notes will accrue to the benefit of the depositors, creditors, stockholders, and to [sic] the general public." (Reg. 4. A. 1–); "The capital notes shall be subordinate in all rights to the bank's liabilities to its depositors, liabilities under bankers acceptances and letters of credit, and any other current obligation characteristic of banking operations." (Reg. 4. A. 3–); and "Capital notes will be considered as part of the capital with respect to Sections 8 and 9 of the Banking Law." (Reg. 4. A. 10–).

Thus the capital note has some of the qualities of stock of Banco Credito, and some of the qualities of a debt

owed by Banco Credito. Like stock, it represents moneys paid into the bank as capital. Like a stockholder, the holder of the note is subordinated to the rights of the general creditors of the bank. The moneys received from both the stock and the capital note are there as the bank's capital, and are there for the protection of the depositors, creditors and the general public (Reg. 4. A. 1–, *supra*) and, in the case of moneys derived from the note, for the benefit of the stockholders. (*Id.*) Surely, if Bank of America had bought stock of Banco Credito, common or preferred, it could not offset its obligation to Banco Credito for the latter's deposits against its investment in the stock.

The subordinated note is not stock, however. It obligated Banco Credito to repay the $5,000,000 over time with interest, and Banco Credito had repaid approximately a million and three quarters dollars, plus interest, when Bank of America attempted to offset the deposits against the notes. There then remained approximately $3,250,000 unpaid, and when the Secretary suspended Banco Credito's obligation to pay, his purpose was to prevent, for the benefit of creditors, any further diminution of the assets of Banco Credito, thereby protecting its depositors and creditors. Thus, at that point, Bank of America was relegated to a position behind the depositors and general creditors of Banco Credito—an eventuality obviously contemplated as possible when Bank of America bought the subordinated note. Whether Bank of America would come ahead of Banco Credito's stockholders of any money was left after the creditors were paid we need not consider; we assume that it would.

The effect of the offset was to defeat the purpose of the subordination of the capital note, to the tune of approximately one million dollars. Not only that, but the effect was also to put Bank of America ahead of all of the depositors and creditors of Banco Credito, by that amount, rather than its being subordinate to their rights. Bank of America kept the million; the depositors and creditors got none of it.

Bank of America argues that setoff is not payment of the subordinated note, and that therefore P.R. Laws, Tit. 7, § 111*(o)* and Regulation No. 4 do not apply. It is true that, technically, "setoff" is not "payment," *New York County National Bank v. Massey*, 1904, 192 U.S. 138, 147-148, 24 S.Ct. 199, 201-02, 48 L.Ed. 380. But that does not answer the question before us. The effect of the setoff was to reduce the amount of the note by $1 million and to deprive Banco Credito of the $1 million that it, or its receiver, could have used to pay its depositors and other creditors.

It is true that, in bankruptcy, a bank has a right to set off a debt that it owes to its bankrupt customer, in the form of a demand deposit, against the customer's debt to the bank, even when the customer, as in this case, is another bank that is insolvent (*New York County Bank, supra,* at 148, 24 S.Ct. at 202), and even though, to the extent of the setoff, the setoff can be said to prefer the offsetting bank to the creditors of the debtor. *See Scott v. Armstrong*, 1892, 146 U.S. 499, 511, 13 S.Ct. 148, 151, 36 L.Ed. 1059; *Studley v. Boylston National Bank*, 1913, 229 U.S. 523, 528, 33 S.Ct. 806, 808, 57 L.Ed. 1313; *Cumberland Glass Mfg. Co. v. De-Witt & Co.*, 1915, 237 U.S. 447, 455, 35 S.Ct. 636, 639, 59 L.Ed. 1042. In the cases cited, the Court reviewed the history of setoff, concluding that it had long been permitted

in courts of equity, and that the express provision for setoff in the bankruptcy statutes simply recognized the right. However, none of the foregoing cases dealt with setoff against a subordinated obligation, such as we have in this case. Here, we are not concerned with the general rule permitting setoff, but with whether it is applicable to this case.

We assume, for the purpose of this case, that there was a sufficient default on the subordinated note by Banco Credito, when the Secretary made his order of June 24, 1977, to trigger the right of setoff, if it existed.

Neither party has cited a case deciding whether there can be a setoff against a subordinated capital note like the one here involved, when the issuing bank becomes insolvent. One case, cited by Bank of America, did involve such a note. *Federal Deposit Ins. Corp. v. Louisiana Nat. Bank*, 5 Cir., 1981, 653 F.2d 927, 930. But there, the question of whether, in the light of the subordination, there could be a setoff, was conceded, if there was a default.

In deciding whether there would be a right of setoff here, absent the setoff clause in the note agreement, we keep in mind that, as Bank of America argues, setoff is a creature of the courts of equity. As Justice Tobriner, speaking for a unanimous California Supreme Court, remarked, "The creditor's right to setoff is not absolute, but may be restricted by judicial limitations imposed to uphold a state policy of protecting the rights of the debtor." *Kruger v. Wells Fargo Bank*, 1974, 11 Cal.3d 352, 367, 113 Cal.Rptr. 449, 521 P.2d 441. Setoff will not be permitted when it would be inequitable or contrary to public policy to do so. We think that here public policy would forbid setoff.

In spite of the "California law" provision of the note purchase agreement, we hold that the provisions of Puerto Rico's statute § 111*(o)* and of its Regulation 4 are the controlling law governing the relationship between Bank of America and Banco Credito, insofar as the setoff is concerned, and that, if confronted by the question, the California courts would also so hold, as a matter of California law. The purpose for which Banco Credito sought the loan from Bank of America was to strengthen its capital position, and Bank of America knew it. The provisions of the Puerto Rican law and regulation, subordinating Bank of America's rights, as lender, to the rights of the depositors and other creditors of Banco Credito, were incorporated in the note and agreement. To permit Bank of America to offset Banco Credito's deposits against its liability on the subordinated note deprives the intended beneficiaries of the subordinated loan, Banco Credito's depositors and creditors, pro tanto, of the very protection that the law, and the subordination provisions of the agreement, were designed to create.

Most closely analogous are cases dealing with assessments upon capital stock or contracts to purchase stock—especially bank stock. In *Sawyer v. Hoag,* 1873, 84 U.S. (17 Wall) 610, 21 L.Ed. 731 Sawyer gave a $5,000 check to an insurance company as payment of the full price of shares of its stock. The company, simultaneously, gave him a check for the same amount, less 15%, i.e. $4,250, and took his note for the $4,250. The company treated Sawyer's stock as fully paid for, and carried the note as an ordinary asset. When the financial condition of the company became shaky, Sawyer bought a loss claim against it, at a discount, and

when a petition in bankruptcy was filed against the company, Sawyer sought to set off the claim against his note. The Court held that he could not do so, in spite of the setoff provision of the Bankruptcy Act. This was because Sawyer's note to the company was a disguised payment for the stock, and, when the company went bankrupt, it became a part of a trust fund—its capital—for the creditors. The Court described the transaction as follows:

> We do not believe we characterize it too strongly when we say that it was a fraud upon the public who were expected to deal with them [the insurance company]. (84 U.S. (17 Wall) at p. 622)

With reference to the Bankruptcy Act, the Court said:

> This section was not intended to enlarge the doctrine of set-off, or to enable a party to make a set-off in cases where the principles of legal or equitable set-off did not previously authorize it.
>
> The debts must be mutual; must be in the same right.
>
> The case before us is not of that character. The debt which the appellant owed for his stock was a trust fund devoted to the payment of all the creditors of the company. As soon as the company became insolvent, and this fact became known to the appellant, the right of setoff for an ordinary debt to its full amount ceased. It became a fund belonging equally in equity to all the creditors, and could not be appropriated by the debtor to the exclusive payment of his own claim. (*Id.*)

The relevancy of the foregoing to the case before us is clear.

Other decisions have reached comparable results. In *Wingate v. Orchard*, 9 Cir., 1896, 75 Fed. 241, this court dealt with an attempt, by a stockholder in a national bank, whose

stock had been assessed by the comptroller of the currency, to setoff against the assessment the amount of his deposit in the bank. This court held that he could not do so, saying:

> Obviously, to permit a holder of stock in such a bank to offset against an assessment for the additional liability thus imposed upon him as such a holder the amount of his deposits in the bank, in respect to which he is no more entitled than any other creditor, would be, in effect, to make him a preferred creditor . . . . Such was not the intention of congress in imposing, as it did, by section 5151 of the Revised Statutes, upon the shareholders of every national banking association, in addition to the amount invested in such shares, a liability for all contracts, debts, and engagements of such association, to the extent of the amount of their stock therein, at the par value thereof. On the contrary, the purpose was, as has been said, to provide a fund to which all creditors should be entitled to look upon equal terms, and in which, in the event of disaster, all creditors, without preference to any, should be entitled to share pro rata. (pp. 242-243)

The analogy between the assessment and the unpaid balance of the subordinated note in the case before us is, we think, compelling.

See also Roth v. Baldwin, D.C.Cir., 1934, 74 F.2d 1003, 1004, citing and following *Wingate; Federal Deposit Ins. Corp. v. de Jesus Velez,* 1 Cir., 1982, 678 F.2d 371, 376, involving subordinated debentures of a Puerto Rican bank; *Walker v. J.B. McCrary Co.,* Ala., 1916, 197 Ala. 638, 73 So. 342, denying setoff to the holder of a subordinated note.

Also relevant and persuasive are cases dealing with a corporation's purchase of its own stock, the seller having received the corporation's note for all or a part of the pur-

chase price. If the corporation becomes insolvent, it has been held that the note holder's claim against the corporation must be subordinated to the claims of the other creditors of the corporation. We so held in *McConnell v. Estate of W.H. Butler*, 9 Cir., 1968, 402 F.2d 362, 366-367, citing and following *Robinson v. Wangemann*, 5 Cir., 1935, 75 F.2d 756, 757-758. In *Matter of Hawaii Corp.*, 9 Cir., 1982, 694 F.2d 179, we cited and followed *McConnell* in a similar case.

The rationale of these cases is stated in *Matter of Hawaii Corp.* as follows:

> The *McConnell* rule is based on the recognition that the capital stock of a corporation is actually a trust fund for its creditors. A corporation that acquires by purchase its own stock in fact distributes a portion of its assets to the selling stockholder. *Robinson v. Wangemann*, 75 F.2d at 757. Because of this fact, when debt securities are issued in exchange for a company's own stock, " '[i]t is necessary to a recovery that the corporation should be solvent and have sufficient surplus to prevent injury to creditors *when the payment is actually made.*' " *McConnell*, 402 F.2d at 366 (quoting *Robinson v. Wangemann*, 75 F.2d at 757-58) (emphasis in original). Until the APG-NATEC notes were paid, appellants' claim on the assets of the issuing corporation was deemed to be that of a shareholder, subordinate to general unsecured creditors. (694 F.2d at 181)

We find this rationale persuasive here, because here the capital note was issued to increase the capital of Banco Credito, primarily for the benefit and protection of its depositors and general creditors. As with a note given to buy the Bank's stock, the subordination becomes important, and therefore must be enforced, when the bank becomes insolvent or "does not have sufficient surplus to prevent in-

jury to creditors when the payment [on the subordinated note] is actually made."

Bank of America relies on cases upholding a setoff of bankrupt's or insolvent's claim against a creditor against the creditor's claim against the bankrupt or insolvent. These cases hold that such setoffs do not create an unlawful preference, even though it is true that the net effect is to put the offsetting creditor in a better position than creditors who owe no debt to use as an offset. *See, e.g., New York County National Bank, supra; Scott v. Armstrong, supra.* But those cases do not involve subordinated claims such as we have here.

Bank of America argues that the fact that a debt is subordinated to the right of other creditors does not preclude the exercise of setoff against it of an obligation owed to an insolvent entity. It cites bankruptcy cases permitting setoff against subordinated debts.

Hayden v. Standard Accident Insurance Co., 9 Cir., 1963, 316 F.2d 598, was governed by the Bankruptcy Act, in which both setoff and the surety's subordination rights were explicitly addressed. The Bankruptcy Act displayed no public policy against the setoffs, as is exhibited in the Puerto Rican statute.

In *Rochelle v. United States*, 5 Cir., 1975, 521 F.2d 844, 845, *modified on other grounds*, 1976, 526 F.2d 405, the court allowed the government to set off tax refunds owing to a bankrupt partner against a bankrupt partnership's tax liabilities, even though partnership creditors were, by statute, subordinated as creditors of individual partners to non-partnership creditors of those partners. This sub-

ordination resulted from § 5g, former 11 U.S.C. § 23g, of the old Bankruptcy Act. We cannot find in that subordination the elements of important ("fundamental") public policy that are present in the case at bar.

In the case at bar there is an important public policy that would be frustrated if the setoff were allowed. The capital note was subordinated by statute for the protection of the depositors and other creditors of Banco Credito —an objective that also protects the FDIC. *See F.D.I.C. v. de Jesus Velez, supra,* 678 F.2d at 375, and *Matter of Weis Securities, Inc.*, 2 Cir., 1976, 605 F.2d 590, 595-596. The subordination also serves the important function of maintaining public confidence in and the stability of the banking system.

As the trial judge said:

> I don't think there's any doubt of the fact that a substantial public interest was involved in the subordination. If there were no provision to the contrary, I would deny offset as being totally inconsistent with the provisions of the subordination.
>
> The whole concept of the subordination was that that money was to be there for the benefit of creditors and depositors [sic] as part of the capital of the Puerto Rican bank and was to be recaptured only under limited circumstances. But all of that is negated of the extent of setoff by the contractual provision. (Tr. of oral argument, CR No. 77, pp. 18-19)

We conclude that, if the note purchase agreement had said nothing about setoff, Bank of America could not have set off Banco Credito's deposits against the subordinated note.

B.

We now turn to the effect of the provision in the note purchase agreement reading: "7.6 Nothing in this Agreement shall be deemed any waiver or prohibition of BANKS' right of banker's lien or setoff." (CR 51, Exhibit B, § 7.6, p. 19).

The trial judge, at the concluding arguments, said:

> I can't see that 7.6 can be talking about any parts of the contract except those that might presumably be thought to limit or waive or prohibit setoff and I don't see anything else in the contract other than the subordination provisions that would seem to be doing that. And it says nothing in this contract waives or prohibits. It must be talking about that. What else would it be talking about? [CR 77 at 33:15–22]

He then held that the agreement did permit the setoff, and gave judgment for Bank of America.

We assume, without deciding, that the judge's construction of the agreement is correct. But we hold that, as applied in this case, § 7.6 of the agreement is invalid because it contravenes the public policy behind the terms of the agreement that subordinate Bank of America's rights to those of the depositors and general creditors of Banco Credito.

The language of the Puerto Rican statute and Regulation No. 4 promulgated under it support this conclusion. The Puerto Rican statute provides that the "capital notes shall be subject *in right* to the obligations with the depositors and other creditors of the issuing bank." P.R. Laws Ann., tit. 7, § 111(*o*) (emphasis added). The regulation clarifies this restriction, providing: "The capital notes

shall be subordinate *in all rights* to the bank's liabilities to its depositors, liabilities under bankers acceptances and letters of credit, and any other current obligations characteristic of banking operations." P.R.R. & Regs., tit. 4, no. 4 (emphasis added). Although neither the statute nor the regulation directly addresses the issue of setoff, the phrases "subject in right" and "subordinate in all rights" indicate an intent, in the event of the insolvency of the bank that issued the capital note, to subordinate the right of offset that the holder of the capital note would otherwise have, to the superior right of the issuing bank's depositors and creditors. Puerto Rico allows banks organized under its laws to issue capital notes only under strict conditions with the aim of protecting "the interests of depositors" and "the economic solvency of the bank." P.R.Laws Ann., tit. 7, § 111(*o*). Private parties may not contract so as to frustrate that aim.

Moreover, the right of setoff could be abused. A large bank holding capital notes could put pressure—perhaps irresistible pressure—upon Banco Credito to increase its deposits with that bank if it thought that Banco Credito's condition was getting shaky. If the right of setoff existed, this would have further reduced the moneys available to Banco Credito's creditors. There is no evidence that there was such conduct here. But the possibility is a further reason for holding that public policy prevents the setoff, in spite of § 7.6 of the agreement.

If the only persons affected by the setoff were Bank of America and Banco Credito, the result might be different. The depositors and other creditors of Banco Credito, however, were not parties to the note purchase agreement, and had no say in negotiating its terms. The Secretary of the

Treasury of Puerto Rico, who approved the agreement, was supposed to be acting for their protection. Considering that duty, we do not think that he had authority to approve § 7.6, insofar as it can be said to purport to permit a setoff after the Secretary ordered the obligation of Banco Credito on the capital note suspended. To that extent, his approval of § 7.6 is a nullity and § 7.6 is void.

IV. *Conclusion.*

The question we have decided is one of law, not one of fact. We reverse the judgment and remand the case to the trial court with directions to enter judgment for the FDIC.

Appendix B

In the United States District Court
for the Northern District of California

Before: Honorable Robert H. Schnacke, Judge

No. C 80-1121 RHS

Federal Deposit Insurance Corporation,
Plaintiff,

vs.

Bank of America National Trust and
Savings Association,
Defendants.

REPORTER'S TRANSCRIPT OF PROCEEDINGS

Friday—July 17, 1981

Appearances

For the Plaintiff:

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For the Defendant:

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Friday—July 17, 1981 2:40 o'clock p.m.

The clerk: Civil 80-1121, FDIC versus Bank of America, cross-motions for Summary Judgment and further proceedings.

Mr. Bordon: Ready for plaintiff. FDIC, David Bordon, B-O-R-D-O-N.

Mr. McElhinny: And for the defendant Bank of America, Harold McElhinny, Andrew Monach of Morrison and Foerster.

The Court: All right. We have cross-motions. They both say the same thing, positive or negative terms, so I guess it doesn't matter much who starts. Let's hear from the plaintiff.

Mr. Bordon: All right, Your Honor.

I guess the point of oral argument for the benefit of the Court probably should be to stress our main points and to try to bring a focus on much of the pages of argument that have been raised.

In 1973, the Bank of America loaned Banco Credito $5,000,000.

The Court: Yes, I know all of the factual predicate.

Mr. Bordon: Yes. If I might, though, I was attempting to get into the matter, Your Honor, but I'll move it along if you'd like.

The point of the loan and the point of our motion is that the agreement to be repaid was an agreement that it wouldn't be repaid prior to depositers and general cred-

itors, Banco Credito. And the real issue from the FDIC's point of view—

The Court: Except possibly by way of setoff?

Mr. Bordon: No. Would you like that point specifically addressed?

The Court: What's the meaning of the provision that says, "nothing in this agreement shall interfere with the right of setoff," or words to that effect?

Mr. Bordon: The concept of setoff in that agreement, I think, has to be interpreted as setoff in the event that the bank had not become insolvent but had defaulted in payments, the right of the Bank of America to collect on the debt had payments become due but the bank not become insolvent.

The Court: You're saying, then, that the setoff right was limited by other provisions in the contract?

Mr. Bordon: Yes. It says—yes, Your Honor.

The Court: Despite the express language that it was not limited by other provisions of the contract?

Mr. Bordon: I think that the express language in the agreement says nothing herein shall affect any right of setoff that may exist in any jurisdiction. There is also the provisions in the agreement that have to be—

The Court: What's the meaning of that? I can't ignore that.

Mr. Bordon: Well, I think I've just focused in on the meaning of it. The Bank of America had a right to timely payments under the agreement. Had banco credito failed—

The Court: I take it that you agree that absent the subordination, there would have been a right of setoff?

Mr. Bordon: Absent the subordination and absent the action of the Secretary of Treasury, that's correct.

The Court: All right. And those—the subordination and the action of the treasury secretary were either specified in or permitted by terms of the contract?

Mr. Bordon: They were specified in the contract, yes.

The Court: So they were terms of the contract, they were other provisions of the contract?

Mr. Bordon: Well, they also had—they also had language that said, "all rights shall be subordinate," so that if anything, Your Honor, there are two inconsistent provisions in—

The Court: It doesn't say "despite anything else set forth in this contract all rights are subordinated," that despite other language of the contract wording appears only in the setoff provision.

Mr. Bordon: I think that the—that the background to that has to be the history by which this note was prepared. The bank—and that is in the record, but I would like to stress it.

Bank of America prepared a standard form promissory note that included the setoff provisions but did not include any subordination provisions or any provisions with respect to action of the secretary. That note was then submitted to the Secretary of Treasury for review. The Secretary of Treasury passed back the note saying that it didn't comply with the laws of Puerto Rico. At that point

the note was then amended to include the language about it shall be subordinate in all rights and that the Secretary of Treasury may suspend payments.

I think that there is—I think that the problem we have here is a drafting problem, that the setoff provision was first in the agreement before the Bank of America took cognizance of the laws of Puerto Rico which prevented the —which prevented the setoff by virtue of the subordination provisions. The setoff provision never changed during the drafting and redrafting of the agreement.

The Court: All right. How about the cases under the old bankruptcy law that deal with subordinated claims?

Mr. Bordon: I think that there are two points that should be made on those. First of all, it's our general position that the bankruptcy act doesn't apply; but talking about the specific cases—

The Court: Let's talk about the rationale of it.

Mr. Bordon: That's—yes, sir.

The Court: The cases there were talking about a statutory scheme that dealt with subordination and isn't that, while it's a different scheme, isn't it substantially the same thing in principle as we're dealing with here?

Mr. Bordon: Well, let's talk about the Allegaert case which is even closer on point, your honor, because that involved not only—that did not involve a statutory scheme but that involved a contract, a contract that had a subordination provision in it and the court was faced with that subordination provision versus the law of bankruptcy and what to do with it. I think that case is really the case that should trouble the court the most of this issue.

The Court: No, it doesn't, because I don't really see any public policy involved in that; whereas, the case involving the interpretation of the provisions of the old bankruptcy law does involve the same—or not the same question and maybe not as serious a question of public policy, but it does involve a public policy consideration.

Mr. Bordon: Well, it involves—it involves, I don't believe, a public policy consideration. What it involves is a question of a priority of claimants—a priority of claimants that was established by law. I don't know that there's a public policy behind it. Certainly—

The Court: I would take it that is to vindicate Congress' idea of some public policy needs.

Mr. Bordon: Well, it—

The Court: It certainly wasn't an arbitrary thing or designed to favor anybody.

Mr. Bordon: I'm—I don't know what the public policy was behind it, but certainly it is not a public policy that—

The Court: It certainly doesn't rise to the same degree as the public policy that would be involved here.

Mr. Bordon: That's correct.

The Court: Why isn't the rationale of those cases—

Mr. Bordon: I think that the problem that I have with those cases is figuring out exactly what the rationale is. Each of those cases talks about mutuality, talks about the question of whether there was mutuality between a creditor and the debtor and makes its decision based upon the issue of the mutuality of creditor and debtor.

There isn't really an extensive discussion in either case with respect to the concept of elevation of a creditor who has either contractually subordinated or is statutorially subordinated. There's no rationale tying either of the cases to get one's teeth into to say either the court is right in what they said, it was well-reasoned or the court was wrong in what they said.

I think that the greatest problem I have with the Allegaert case, for example, is they don't cite us the subordination provision. They don't tell us what was involved in the subordination provision and they go off on the issue of mutuality. Was it a mutual debt between creditor and debtor? In fact, it isn't apparent from the decision that an argument was—the nature of the argument that might have been made with respect to subordination and why the subordinated debtor should not wait. All the court says is that we have a mandate from congress. It's expressed in section 68 and there is mutuality:

It's—I think that whereas on the one hand you have those three bankruptcy cases, you also have the expression of the United State Supreme Court in the *Baker* case as well as the district court case in the *Penn Central* where there's a rather extensive discussion in both cases about the weighing of the concept of a subordinated debtor versus the concept of setoff. And in both cases the court comes out differently than the courts in either Allegaert or the other bankruptcy case—the other two bankruptcy cases.

I mean, for some reason when the Supreme Court in Baker discussed setoff and when the district court in Penn Central discussed setoff, they both focused in on the rationale behind a subordinated debt, the rationale behind a pri-

ority of creditors and on the other hand the equitable principle of setoff. And in both cases the court came out that the more important principle was the principle of a subordinated debt and that you couldn't use setoff to climb ahead of a creditor to whom you had expressly agreed to take after. Those cases are reasoned.

It's also interesting, I think, that in both of the cases they talk about the equitable considerations of a subordinated lender versus this procedural remedy of self-help in setoff. Whereas, the court in Allegaert doesn't consider equity. In fact, it says it's not able to consider the equitable arguments because the bankruptcy code doesn't give it the latitude to do that.

The Court: Anything further?

Mr. Bordon: Well, obviously Your Honor has read the briefs extensively. The only thing else I would add would be on the issue of nature of the subordinated debt and why it is an important federal public policy. That the subordinated debt gives the bank the right to exist. It gives the right to take in more deposits. It's the cushion from which an insolvent bank has to pay depositers. And to allow the setoff of that debt is to attack this fundamental basis upon which the bank has to build its entire depository scheme.

I think that that's obviously the reason for the extensive statutory scheme in Puerto Rico with respect to the control of subordinated debt by the Secretary of Treasury. The right to review this debt, the right to require that certain terms and provisions with respect to subordination and suspension be in the notes; that there is a very important public policy and that the Bank of America contracted with the knowledge of that public policy.

As we have pointed out in our affidavits which have attached the minutes of the general loan committe of the Bank of America, the Bank of America knew that the loan was to increase the ratio of assets to deposits. They knew that this was statutorily required by Puerto Rico, that the Banco Credito needed more money in order to support its deposits. And yet five years after entering into this contract, they offset.

I could go on for a long time, but if the court doesn't have any specific questions, it's apparent—

The Court: Let's hear from your opponent.

Mr. Bordon: Huh?

The Court: Let's hear from your opponent.

Mr. Bordon: Okay.

Mr. McElhinny: Harold McElhinny, Your Honor, for Bank of America. Briefly—

The Court: Are there equitable considerations here?

Mr. McElhinny: No, Your Honor, I don't think there are and I'll tell you why.

The Court: Is setoff an equitable right?

Mr. McElhinny: It is an equitable right, that's correct, your honor, and to that extent I do think there are equitable considerations; but I think the perspective in which this case is taken is very important.

Every case which has dealt with a receiver—this is a collection matter. This is not a suit—we're not challenging the scheme which the FDIC has set up in Puerto Rico to

pay out any assets that are marshaled. This is a case in which—

The Court: We're just undercutting the scheme of the administrator out there in refinancing the bank at the outset.

Mr. McElhinny: Even that isn't true, Your Honor, if you see the distinction. Every case that has ever dealt with a bank receivership has pointed out that when the receiver comes in and sues for collection, he stands in the shoes of the insolvent. He has no greater equities. *Scott* versus *Armstrong* says that, definitely says that, the Ninth Circuit has said that in *FDIC* versus *Di Mayo* (phonetic). I think there's no question but if Banco Credito was the person who was the plaintiff in this case, and if they were suing Bank of America, the equitable interests that apply in this case, the collection case, would be apparent because from the time of the ancient Romans, as we've shown, the courts have never allowed an insolvent to sue on its debt without allowing the creditor to set off any debts that are owing.

By confusing the fact that we have two lawsuits and treating it as one, the FDIC points the finger in the wrong direction. While the bank may have relied on—while the depositers may have relied on the capital of the bank, they did not—they could not rely on the existence of the accounts which were set off in this case because they are not capital of the bank. They were the property of the Bank of America, they were debts owed to the bank by Bank of America and could not be used in calculating the net assets of the bank.

And, therefore, the amounts that we're talking about in this collection matter—and I believe that's the reason why

in all of the cases that we're dealing with in subrogation, the equities that are involved in that case, the equity of whether the insolvent or whether it's any other person who stands in that person's shoes with no greater equity is entitled to prevent the right of setoff. And from that perspective I think the equitable answer comes out pretty clearly and the rationale for the court's—all of the court's decisions is clear.

I would like to briefly just correct two things that were said. One, as Your Honor has pointed out, the exact wording of the provision in the contract is, "nothing in this agreement shall be deemed any waiver or prohibition of bank's right of banker's lien or setoff."

Secondly, just again to correct, the original note purchase agreement, the original agreement that was submitted to the secretary of the treasury, did in fact contain a subordination clause. And that is in the court's papers. It's Exhibit E to the affidavit of Senor Casellas, the former Secretary of the Treasurer submitted by FDIC. The subordination clause is paragraph 1.4. Now, when the secretary reviewed the document it's true he made the subordination clause broader, but he did not change paragraph 7.6.

In think that this case is controlled by the *Hayden* case in the Ninth Circuit. In that case the court was dealing with the bankruptcy act and it was dealing with the statutory subordination of a surety's interests; and it pointed out, and the case is true here, that every person who loans as a surety must know that in case of insolvency his claim will be subordinate but it allowed the claim of set off. And it said, just as Justice Friendly—as Judge Friendly said *In Re Applied Logic*, that given the history of setoff, given

the favor in which it has been looked on historically by the courts, if the administrative agencies, if the Congress, if the Secretary of the Treasury of Puerto Rico wanted to change the way that the law has traditionally been applied, they have the power. They could have changed Regulation Four, they could have changed this specific agreement, but they did not do so; and it wasn't until after the matter had come and the receiver has stepped in that it's trying to gather itself in the cloak of public policy. The cloak which the Ninth Circuit in *FDIC versus Di Mayo* has said does not increase its equitable standing.

Every person who loans money to a bank knows that in the case of insolvency all that person will be entitled to is a rateable distribution. They know that and yet the courts have always allowed that person to set off in the case of that bank's insolvency. There's no difference here.

Arguments that go against setoff generally have been rejected by the courts, they've been rejected by the Ninth Circuit. I don't see that the policy arguments are different in this case.

Mr. Bordon: The problem with the Bank of America's argument, I believe, is that for some reason the setoff concept has taken a—a greater—it has become a greater remedy than it was either intended to be in the history of setoff or as is expressed in the law. The concept of setoff was to prevent the circularity of suit when a creditor and a debtor had mutual debts. But it's not being used for that purpose in this case. It's being used to defeat rights that were contractually agreed to between the two parties.

What the setoff provision is being used for is to say, "irrespective of any contractual rights that may have been

agreed to by the parties, as long as there was money owing between them, all those contractual rights are eliminated. All of them are without force and effect."

And there isn't really any setoff case that goes that far. Setoff cases talk about the issue of whether when a debt—when a debtor becomes insolvent the debt matures, and whether upon insolvency and maturity there's a mutuality between the two parties. But it's a timing issue. The whole concept of insolvency and maturity is really a timing issue that the courts say, "Look, we're not going to say that the debts aren't mutually extinguishable because one isn't due for a period of time." This is a much different case here. The setoff provision is being used to defeat what was the contractual agreement of the two parties.

Subordination can only have a meaning in insolvency. There is no other time that subordination in general or the subordination in this case would have any meaning.

To allow insolvency is to read—

The Court: The same thing, unfortunately, is true of the provisions of Section 7.6 as a realistic matter. Banks do not go around claiming offset against the deposits of other banks absent something rather unusual going on in the affairs of the depositing bank. Offset is, as we're all perfectly well aware, an unusual remedy that's taken in case of the fiscal problems of the depositing bank. And I can't think of 7.6 as being a provision that deals exclusively with some possible situation in which the Puerto Rican bank isn't really in any financial trouble but it's simply failing to pay its bills. That's not the kind of situation that is reasonably to be contemplated when you're considering offset or setoff.

Mr. Bordon: In that same mode—

The Court: I will follow your arguments all the way insofar as the respective rights of the party absent to provisions of 7.6. I don't think there's any doubt of the fact that a substantial public interest was involved in the subordination. If there were no provision to the contrary, I would deny offset as being totally inconsistent with the provisions of the subordination.

The whole concept of the subordination was that that money was to be there for the benefit of creditors and depositers as part of the capital of the Puerto Rican bank and was to be recaptured only under limited circumstances. But all of that is negated to the extent of setoff by the contractual provision. We're not dealing here with a contract of adhesion, we're dealing here with a contract that was carefully worked out between mature, sophisticated parties who presumably knew what they were bargaining for and what they were dealing with.

The concept of setoff has plagued banks one as to the other in situations like this for years. It isn't the kind of thing that you would say the parties would never have thought about. I must assume that they did think about it and that this was an intelligently arrived at contract with a provision dealing with the respective rights on—in all of the reasonably to be anticipated circumstances.

And one of the things very reasonable to consider here in the light of the relationships between Puerto Rican bank and the Bank of America is the fact that there were going to be deposits on hand and that the bank was going to exercise its right of setoff. And in the strongest language pos-

sible they say, "regardless of what anything else in the contract says, there's no waiver or limitation on the setoff right."

Now, how can I ignore that?

Mr. Bordon: But I think that the issue can easily be turned the other way, Your Honor. We have postulated one obvious circumstance in which the Bank of America loaning money would want the right of setoff which is a default in payment.

The Court: I know, but that—that's not a realistic concept.

Mr. Bordon: Why?

The Court: That sort of thing doesn't happen. If there is a default in payment to the bank, Puerto Rican bank is in difficulties and they're on the brink of something unhappy. Banks don't go around defaulting on their obligations like this in the ordinary course of business. That's behavior that is the preliminary to or an adjunct of insolvency.

Mr. Bordon: But as the counter to that, Your Honor, what was the purpose of the subordination provisions if upon any financial difficulty or if upon insolvency there could be an automatic setoff?

The Court: Well, obviously the bank was not going to enter into this agreement unless it was entitled to setoff.

Mr. Bordon: Then the court—

The Court: They in effect reserved the right to setoff regardless of anything else in the contract.

Mr. Bordon: Well, then, the—I think the problem that that argument runs up against is that the note and the Note Purchase Agreement were transacted under the laws of Puerto Rico which under your reading of the contract would mean that the contract was ultravirus. They were not allowed in Puerto Rico to enter into a note agreement other than a subordinated note agreement.

The Court: They entered into a subordinated note agreement.

Mr. Bordon: But you're reading the contract such that the subordination provisions have no meaning.

The Court: They have all sorts of meaning. The bank is stuck with a substantial amount here. Their remaining claims are subordinated.

Mr. Bordon: Well, that's not the way the contract reads. The contract reads that all their claims, in fact all their rights are subordinated.

The Court: Except to the extent that they can be recouped on setoff.

Mr. Bordon: But the court's interpretation of the setoff provision would be that it would in all cases be in effect. You couldn't—that if there had been $5 million on deposit, that could have all been setoff.

The Court: It could very well be.

Mr. Bordon: But then the subordination provisions had no import.

The Court: It has import to the extent that there are nonsetoff claims. That's what the contract says. I can't rewrite the contract. I can visualize all sorts of circum-

stances in which somebody down there may have failed to think about it, but I don't find any evidence of overreaching. I don't find it a contract of adhesion. I find it a contract between mature, sophisticated contracting parties and I find it a contract in which there were drafts and redrafts, there were negotiations dealing with it and I have to assume that the terms of it have meaning.

And I can't give any valid reading to 7.6 except that it means what it says and that the subordination agreement doesn't affect the—doesn't constitute any waiver or prohibition against setoff.

What else in the agreement might have constituted some waiver or prohibition of setoff? What else was there that that could be talking about other than the subordination?

Mr. Bordon: Well, there was a multistructured debt structure of the bank. The bank's debt included other subordinated lenders. In other words, the Bank of America was not the first subordinated lender that had made loans to this bank. The whole—

The Court: I understand that.

Mr. Bordon: The Bank of America, while subordinating to depositers and general creditors, did not subordinate to other subordinated creditors. It wanted to be—

The Court: My point is: What else is there in the contract that could be read as a waiver or prohibition of setoff other than their agreement to subordinate to the extent that they so agreed? Where else would you find anything that could be interpreted as a waiver of prohibition of setoff?

Mr. Bordon: Well, I think that the answer to that, Your Honor, is that while it is not a contract of adhesion, while it was a contract that was bargained for, this was a pro forma clause that was in all the Bank of America loan agreements and that it was not given the attention in the drafting of the agreement that the court now reads into it, that the history of the agreement was a focus upon the subordination provisions of the agreement.

For example, in the general loan committee of the bank, when they approved this loan, they knew it was a subordinated loan to improve the capital. They don't have any caveats in that loan agreement or by which the loan was approved—I mean, in the loan committee memorandum they don't have any caveat but we want to reserve the right of setoff. I think that the problem here was a problem in drafting, that it started with a pro forma document that had been prepared by the bank.

In fact, Mr. Errant (phonetic) who testified that—

The Court: I don't know what would have happened had the question been raised. It may very well be that the bank would have said, "Okay. We waive our right of setoff." But pure speculation to deal with that. The fact remains that they didn't.

You know, the contractual provision raises the question right there in the contract. I have to presume at least that the Puerto Rican people read the contract. And here's this business of setoff and it's a red flag to them. Obviously all they had to do to avoid it was not to make any deposits.

Mr. Bordon: Well, the deposit relationship had been in effect before the loan had come into effect, Your Honor.

The Court: I haven't read the loan agreement carefully enough to recall whether there was any requirement of maintaining a balance with Bank of America.

Mr. Bordon: There was none. And, in fact, the document submitted—

The Court: All they had to do to avoid the setoff was to see to it that there was nothing to set it off against. They could have protected themselves. Keep their deposits elsewhere where there wasn't any setoff right.

But as I say, here's the word "setoff" standing out bright and clear in the agreement. Those bankers, they knew perfectly well what that meant and they knew perfectly well that they were not avoiding that risk.

Mr. Bordon: Well, I think that to read the contract that way is to defeat the other provisions of the contract as well as defeat Puerto Rican law with respect to this capital note because if the bank—

The Court: I don't see any Puerto Rican law that forbids the setoff right.

Mr. Bordon: It says that—

The Court: Is there anything in the law that says that the—as a matter of fact, this contract was ultimately approved in this form by the secretary; wasn't it?

Mr. Bordon: That's not in the record, Your Honor. I don't know the answer to that.

The Court: Well, I guess I'm presuming that from the fact that he had some original input into the requirements of the contract.

Mr. Bordon: And he made certain provisos under which—

The Court: He made certain provisos, so I would assume from that if he was looking at an early draft, it would make some sense to think that he probably looked at the last draft before it was signed.

But, in any event, I haven't been referred to anything in the Puerto Rican law that refers to any limitation on setoff.

Mr. Bordon: Two points on that, though, Your Honor. First is that the Puerto Rican law says that it shall be subordinate in all rights. I mean, that proviso is as broad as the proviso that nothing herein shall affect the right of setoff. "In all rights" could easily be read to include the right of setoff. It shall be subordinate—I mean, the right of—the statute reads that the right of payment may be suspended and that all rights under the agreement shall be subordinate. All rights under the agreement, not just the right to payment shall be subordinate to that of depositers but all rights. That's the statutory scheme in Puerto Rico.

Furthermore, Puerto Rico doesn't recognize setoff. Puerto Rico statutorily prohibits setoff of deposits between banks.

The Court: So you're saying, then, that 7.6 is an illegal provision under Puerto Rican law to the extent that it's sought to be applied here?

Mr. Bordon: That's right. I think that if the court thinks that 7.6 is broad in its ambit because of the words "it shall be"—that "nothing herein shall affect the right of setoff," the statutes of Puerto Rico are as broad where it

says, "all rights shall be subordinate." Those two provisions—those two things are really contrary to one another.

The Court: What do we do if the contract of 7.6 is illegal?

Mr. Bordon: You read it out into Puerto Rican law.

The Court: Just eliminate it?

Mr. Bordon: Yes.

The Court: All right. How about that, counsel?

Mr. McElhinny: Your Honor, a couple points. Section 7.7 of the contract, which was also approved by the Secretary of Treasury Puerto Rico, says that the statute will be interpreted under California law.

Number two, the deposits which we are talking about having been set off were in banks in the Virgin Islands and in San Francisco. Our setoff is completely legal under the Virgin Islands law and California law which specifically was the law that was to apply to the contract. These, again, were rights that were put in the contract that were submitted to the Secretary of the Treasury and were approved.

Standard choice of law, which we've cited in our reply memo and specifically California Commercial Code Section 4.102, says that the law that applies to a question of the law that governs the deposit is the law of the place where the bank or the branch is located. And in this case—in this lawsuit, the suit by the receiver against the Bank of America for the accounts, the deposits, there's no contact with Puerto Rican law whatsoever.

The only question, again, is whether or not some earlier contract would have surrendered the right that exists—

that Bank of America had in California and had in the Virgin Islands; and as I think Your Honor has pointed out, there is nothing in that contract which does that. And it's a bootstrap to say that if setoff were illegal in Puerto Rico, it would also be illegal to enter into a contract which recognized a legal right of setoff in California or in the Virgin Islands. That doesn't follow.

The Court: Do you want to respond to that?

Mr. Bordon: Well, I don't think that the choice of law issue is as simple as it's made out to be. Number one, the contract which is the loan agreement did have a provision in it that the contract will be interpreted under California law. But the contract for the loan was entered into in Puerto Rico under the ambit and guise of a loan that was under the jurisdiction of the laws of Puerto Rico. It was under the jurisdiction of the Secretary of Treasury and it was under the jurisdiction of Regulation Four of the Secretary of Treasury and the laws of Puerto Rico.

It's clear that both the Bank of America and Banco Credito, irrespective of a provision in the contract about what law applies, recognized that for supervisory purposes, for purposes of determining whether this loan could be entered into, for purposes of determining the provisions of the loan, had to adhere to Puerto Rican law.

And the clear statutes in Puerto Rico require that it be subordinate in all rights; and, therefore, to the extent that there is a clause in the contract that provides that it shall not hinder other rights including the right of setoff has to be read out of the contract.

With respect to the choice of law on the issue of setoff I thing that's a different issue.

The Court: I take it the Puerto Rican bank had the right, without the authority of the secretary in Puerto Rico, to enter into whatever kind of a contract it wanted here.

Mr. Bordon: No, it did not.

The Court: It was only the question of what the effect of that contract would be on the future vitality of the bank that was of interest to the secretary. Am I wrong about that?

Mr. Bordon: Yes, you are, Your Honor, in that Regulation Four as well as the statute provides that all banks which enter into capital note agreements are doing it under the jurisdiction of the secretary. It then gives the secretary the right to review the document, it gives the secretary the right to require that provisions be in the document and it is under his supervisory and regulatory authority explicitly.

Mr. McElhinny: If I may, one thing, Your Honor. This is just another factual correction. The record does not state where the contract was entered into. In fact, it was signed in New York City and it was signed in New York City with the agreement of everyone to particularly avoid——

The Court: I take it the point is not too strenuously urged about where it was entered into.

Mr. Bordon: No.

Mr. McElhinny: Thank you.

The Court: What kind of a contract it had to be under the Puerto Rican law. And the suggestion is that the Puerto

Rican law would for some reason forbid remedies lawful where pursued if they happened to be unlawful in Puerto Rico. I'm afraid I can't accept that view of setoff.

On the other hand, there is some problem with the intendment of the Puerto Rican law and administration of it that all of this obligation was to—that none of this obligation was to be paid in any fashion unless others were taken care of first.

Mr. McElhinny: If I may, Your Honor, I think the clearest argument on that point is the argument that counsel has just made. Under Puerto Rican law this contract could not be signed without the approval of the Secretary of the Treasury Puerto Rico. He in fact reviewed it. He in fact sent out a letter that said it will not be approved until the following changes were made. Those changes were made and the contract was signed.

The Secretary of Treasury of Puerto Rico at the time the document was signed had no problem with Section 7.6, and he had no problem with Section 7.7 which said that California law will interpret it. It's now that it's being suggested for the first time in this lawsuit that that's contrary to Puerto Rican law and, again, there's no support for that.

Mr. Bordon: Well, Your Honor, it's the first time that the setoff was attempted. In other words, it's our position that there is nothing that would have prevented setoff under certain circumstances. The court says that he can't—that it can't understand all those circumstances as ever being present, but there are circumstances in which setoff would be allowed.

The Court: I'm not saying that there might not be rare instances in which setoffs might not be applied in case of absence of some financial difficulty of the depositer, all I'm saying is that setoff is normally thought of as a remedy on the occasions where the depositer is in some financial difficulty, and that concept of it certainly must have been in the minds of the parties when they were bargaining.

As I say, I have every reason to believe that the intendment of the structure of the Puerto Rican law was that this money shouldn't be repaid in any fashion; but neither the secretary nor the Puerto Rican bank saw to it that the contract provided for that and I'm limited to enforcing the terms of the contract and the rights that arise under it.

And under the laws of California, the setoff is appropriate, the contract by its terms says that nothing in it waives or prohibits the exercise of that right. The laws of the Virgin Islands it's the same matter.

And while I'll grant you that there is a certain degree of frustration in the expectations of the other creditors, the depositers and the FDIC in what happens here, but it's not the Bank of America's fault. It's the Puerto Rican bank's fault and the secretary's fault for drafting the contract in this fashion.

Mr. Bordon: Your Honor, the secretary reviewed the contract and approved it subject to its being corrected to include all these provisions with respect to the subordination. If in—

The Court: If you had other objections to the contract, obviously he could have indicated his objections there. In effect, he redrafted the contract. And, as I say, whether he

approved it or whether the parties proceeded on the assumption that accommodating his comments was sufficient to incorporate his approval, for whatever reason we wind up with a contract and the contract has provisions in it that simply don't fully protect the expectations apparently of the people in Puerto Rico.

Mr. Bordon: Well, also a contract then that while under the law of Puerto Rico doesn't comply with those laws.

The Court: As I understand the laws of Puerto Rico, they are that the contract must have the approval of the secretary.

Mr. Bordon: But they also are that everything—that all rights in the contract and all rights shall be subordinate to depositers and general creditors.

I mean, we can't get away—the—a lot can be read into the approval process of the secretary, whether it's justified or not is a question. But you can't reread the statute or reinterpret the statute under which he acted and under which the agreement was drawn which says that all rights shall be subordinate.

The Court: All right. And they are.

Mr. Bordon: Ah, but not if you permit setoff.

The Court: Well, but we know that in other instances setoff is permitted against subordinated agreements.

Mr. Bordon: Only in one case, district case in bankruptcy.

The Court: All right. So it isn't per se inherently impossible for that to occur and that isn't a matter of violating the subordination arrangements.

Well, I wish the ruling could be to the contrary because I do have strong feelings that the Bank of America really should be leaving this investment where it was placed and in a properly drafted agreement that's what would have happened. But I must yield to the precise language of the agreement, that as I see it has specifically reserved to them the right of setoff under these circumstances. Where the parties have agreed to it, I see no way where I can take it away from them.

Mr. Bordon: May I ask the court one question, which is where the court feels that there is an ambiguity in the contract between those two provisions, between the absolute provisions of—

The Court: I don't see any basis for ambiguity. I can't see that 7.6 can be talking about any parts of the contract except those that might presumably be thought to limit or waive or prohibit setoff and I don't see anything else in the contract other than the subordination portions that would seem to be doing that. And it says nothing in this contract waives or prohibits. It must be talking about that. What else would it be talking about?

I'm sorry, but I take it the amount's agreed on?

Mr. Bordon: Yes. Well—

Mr. McElhinny: Yes. It's agreed that there are not amounts in controversy that exceed the amount of the debt.

The Court: All right. Very well. On that basis summary judgment will be entered for the United States—

Mr. McElhinny: I'm sorry, Your Honor.

The Court: On the basis of the findings—entered for the Bank of America on the basis of the findings and facts and conclusions of law that I've indicated during my discussion with you.

Mr. McElhinny: It will be entered in favor of the Bank of America, Your Honor?

The Court: Bank of America.

Mr. Bordon: Thank you, Your Honor.

Mr. McElhinny: I have an order which is in the form of the proposed.

(Pause in proceedings.)

The Court: Yes. Would you submit a separate form of judgment, Counsel?

Mr. McElhinny: Yes, I will, Your Honor.

The Court: Thank you, gentlemen.

(Proceedings concluded at 3:30 o'clock P.M.)

Appendix C

United States Court of Appeals
for the Ninth Circuit

No. 81-4590

Federal Deposit Insurance Corporation,
Plaintiff-Appellant,

vs.

Bank of America National Trust and Savings Association,
Defendant-Appellee.

Before: DUNIWAY, PREGERSON and BOOCHEVER, Circuit Judges

[Filed May 6, 1983]

ORDER

The panel as constituted in the above case has voted to deny the petition for a rehearing and to reject the suggestion of a rehearing in banc.

The full court has been advised of the suggestion for in banc rehearing, and no judge of the court has requested a vote on the suggestion for rehearing in banc. F.R. App. P. 35(b).

The petition for a rehearing is denied and the suggestion of a rehearing in banc is rejected.

Appendix D

12 U.S.C. § 1819 (1976)

Fourth. [. . .] All suits of a civil nature at common law or in equity to which the Corporation [FDIC] shall be a party shall be deemed to arise under the laws of the United States [. . .]

12 U.S.C. § 1823(e) (1976)

(e) [. . .] No agreement which tends to diminish or defeat the right, title or interest of the Corporation [FDIC] in any asset acquired by it under this section, either as security for a loan or by purchase, shall be valid against the Corporation unless such agreement (1) shall be in writing, (2) shall have been executed by the bank and the person or persons claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition of the asset by the bank, (3) shall have been approved by the board of directors of the bank or its loan committee, which approval shall be reflected in the minutes of said board or committee, and (4) shall have been, continuously, from the time of its execution, an official record of the bank.

Appendix E

California Code of
Civil Procedure § 431.70 (1973)

Where cross-demands for money have existed between persons at any point in time when neither demand was barred by the statute of limitations, and an action is thereafter commenced by one such person, the other person may assert answer the defense of payment in that the two demands are compensated so far as they equal each other, notwithstanding that an independent action asserting claim would at the time of filing answer be barred by the statute of limitations. [. . .] Neither person can be deprived of the benefits of this section by the assignment or death of the other.

California Commercial Code § 4102(2) (1964)

(2) The liability of a bank for action or nonaction with respect to any item handled by it for purposes of presentment, payment or collection is governed by the law of the place where the bank is located. In the case of action or nonaction by or at a branch or separate office of a bank, its liability is governed by the law of the place where the branch or separate office is located.

Appendix F

V.I. Code Ann. tit. I, § 4 (1967)

The rules of the common law, as expressed in the restatements of the law approved by the American Law Institute, and to the extent not so expressed, as generally understood and applied in the United States, shall be the rules of decision in the courts of the Virgin Islands in cases to which they apply, in the absence of local laws to the contrary.

V.I. Code Ann. tit. IIA, § 4-102(2) (1965)

(2) The liability of a bank for action or non-action with respect to any item handled by it for purposes of presentment, payment or collection is governed by the law of the place where the bank is located. In the case of action or non-action by or at a branch or separate office of a bank, its liability is governed by the law of the place where the branch or separate office is located.

Appendix G

P.R. Laws Ann. tit. 7, § 111(o) (1981)

(o) With the approval of the Secretary of the Treasury, a bank organized under the laws of Puerto Rico may issue capital notes. Such capital notes shall be subject in right to the obligations with the depositors and other creditors of the issuing bank and may not be issued for a maturity period longer than 20 years. The Secretary of the Treasury may suspend the payment of the principal of and interest on capital notes on or before they fall due, when such payment may reduce the aggregate total amount of the capital stock, reserve fund and capital notes, and when in his judgment such payment may affect the economic solvency of the bank and endanger the interests of the depositors and of the public in general. Capital notes shall be considered as part of the capital for the purposes of sections 35 and 36 of this title; but shall be presented and designated separately in all statements of condition and shall not be subject to the payment of taxes. No bank may acquire its own capital notes as investment of its trust funds or for its portfolio.

Regulation No. 4

To regulate the issuance of capital notes by banks in Puerto Rico.

A. The issuance of capital notes by banks in Puerto Rice shall be subject to the following conditions and restrictions:

1. All issuances of capital notes shall require the prior approval of the Secretary of the Treasury. In order to grant his approval, the Secretary of the Treasury will take into consideration the capital needs of the bank, its financial condition and if the said

issuance of capital notes will accrue to the benefit of the depositors, creditors, stockholders, and to the general public.

2. Applications for the issuance of capital notes shall be submitted in the form prescribed by the Secretary of the Treasury, which application shall be accompanied by (a) copy or facsimile of the capital note, (b) copy of the contract with the purchasers, (c) copy of the study that the bank has made to justify the issuance of the said capital notes and which explains their probable effect upon the financial condition of the bank, and (d) copy of the resolution approved by not less than two-thirds (⅔) of the members of the Board of Directors authorizing the issuance of said notes.

3. The capital notes shall be subordinate in all rights to the bank's liabilities to its depositors, liabilities under bankers acceptances and letters of credit, and any other current obligation characteristic of banking operations.

4. Capital notes shall not be issued in an amount which would exceed 50% of the paid-in capital stock plus 50% of the reserve fund.

5. Capital notes may not be issued for a maturity period in excess of 20 years.

6. No capital notes may be issued which are convertible into common stock of the Bank.

7. To submit to the approval of the Secretary of the Treasury a plan to guarantee that at the end of the period of issuance there shall exist in the redemption fund, which the bank shall create, sufficient money for the total retirement of the notes issued. There shall be segregated from the profits of the bank the amounts of money that may be required by this plan.

8. The Secretary of the Treasury may suspend payment of the principal and interest of the capital

notes on or before their due date, when such payment reduces the sum of the capital stock, capital notes and reserve fund and when in his judgment such payment may affect the financial solvency of the bank and endangers the interest of the depositors and the general public. This condition shall form part of the contract with the purchasers of the capital notes and in addition shall be included in the text of the capital note.

9. The funds obtained by the issuance and sale of capital notes, after said notes are redeemed, shall only be used to increase the capital stock and/or the reserve fund.

10. Capital notes will be considered as part of the capital with respect to Sections 8 and 9 of the Banking Law.

11. No bank shall acquire its own capital notes for investment of trust funds or for its own investment portfolio or be accepted as guarantee of any kind.

B. Violations of the provisions of this Regulation shall be punished with an administrative fine not greater than one thousand dollars ($1,000.00) for the first offense, and for the second, an administrative fine which shall not exceed five thousand dollars ($5,000.00) imposed by the Secretary of the Treasury, and the cancellation of its license by the Superior Court.

No. 83-198

In the Supreme Court of the United States

OCTOBER TERM, 1983

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, PETITIONER

v.

FEDERAL DEPOSIT INSURANCE CORPORATION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether the court of appeals correctly held that petitioner, a holder of a subordinated capital note of an insolvent bank in receivership, could not set off that subordinated claim against its obligation on a deposit of the receivership.

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TABLE OF AUTHORITIES

Cases:

In the Supreme Court of the United States

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A20) is reported at 701 F.2d 831. No formal opinion was issued by the district court, but the transcript of the July 17, 1981, hearing is set forth at Pet. App. A21-A48.

JURISDICTION

The judgment of the court of appeals was entered on March 18, 1983 (Pet. App. A1). A petition for rehearing was denied on May 6, 1983 (Pet. App. A49). The petition for a writ of certiorari was filed on August 4, 1983. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Banco Credito y Ahorro Ponceno ("Banco Credito") was a banking corporation organized and existing under the laws of the Commonwealth of Puerto Rico and regulated by the Secretary of the Treasury of the Commonwealth of Puerto Rico ("Secretary"). Its deposits were insured by the Federal Deposit Insurance Corporation ("FDIC").

On November 1, 1973, Banco Credito, for the purposes of strengthening its capital, submitted to the Secretary an application for permission to issue capital notes to a consortium of various banks led by petitioner, including a capital note to petitioner itself in the sum of $5 million (Pet. App. A1-A2). Puerto Rican law provides that such capital notes may be issued only with the approval of the Secretary and that they are "subject in right to the obligations with the depositors and other creditors of the issuing bank * * *." P.R. Laws Ann. tit. 7, § 111(*o*) (1981) (reprinted at Pet. App. A53). Moreover, Regulation No. 4 of the Secretary (see Pet. App. A53-A55) provides that such notes are subordinate in their rights to the claims of depositors and other creditors and that the Secretary is authorized to suspend the obligations of the issuing bank under certain specified circumstances to protect the public interest.

On December 27, 1973, Banco Credito and petitioner entered into a note purchase agreement, which incorporated the requirements of Regulation No. 4. The agreement noted that the funds were to be used to improve the ratio of Banco Credito's capital funds to its deposits. The agreement also contained a clause providing that "[n]othing in this agreement shall be deemed any waiver or prohibition of [petitioner's] right of banker's lien or setoff." On December 28, 1973, Banco Credito executed a subordinated capital note in favor of petitioner in the principal amount of $5 million. See Pet. App. A2.

Banco Credito made timely payments on the note until June 24, 1977, when the Secretary, acting pursuant to Regulation No. 4 and the terms of the note, ordered further payments suspended. On March 31, 1978, Banco Credito was declared insolvent by the Secretary and, pursuant to P.R. Laws Ann. tit. 7, § 201 (1981), the Secretary assumed control of Banco Credito for the purpose of its total liquidation. The FDIC was appointed as receiver pursuant to 12 U.S.C. 1821(e). Pet. App. A3-A4.

The FDIC embarked upon the liquidation of Banco Credito through a "purchase and assumption" arrangement under which the FDIC sold certain marketable assets of Banco Credito to Banco Popular, another Puerto Rican bank. See 12 U.S.C. 1823(e). Among the assets purchased by Banco Popular was approximately $1 million that Banco Credito had on deposit with petitioner. When Banco Popular asked to withdraw these funds, petitioner refused the request on the ground that the deposits were being applied as a setoff against the Banco Credito subordinated capital note obligation. Pursuant to the purchase and assumption agreement, the receivable represented by the deposit— being uncollectable — was returned to the FDIC, and was subsequently purchased by the FDIC in its corporate capacity. Pet. App. A3-A4.

2. The FDIC brought this action in the United States District Court for the Northern District of California seeking to recover the funds that Banco Credito had on deposit with petitioner. The district court granted summary judgment for petitioner on the ground that the note purchase agreement explicitly preserved petitioner's right of setoff (Pet. App. A21-A48). The court of appeals reversed (*id.* at A1-A20). The court held that federal common law was applicable, but that, because no rule of federal common law addressed this situation, other sources of law were relevant (*id.* at A5-A6). Looking to the Puerto Rican law embodied

in the note agreement, the court explained that the purpose of the subordination provision was to protect the rights of depositors and to elevate their claims unmistakably above those of an investor providing capital to a bank. Hence, petitioner would not ordinarily have a right to set off its deposits against the unpaid capital note because that would effectively destroy the subordination provision (*id.* at A8-A17). Finally, the court concluded that the setoff provision in the agreement could not operate to alter this subordination (*id.* at A18-A20).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court. The court of appeals' decision simply follows the longstanding rule that capital of a bank receivership may not be appropriated through setoff by a debtor of the receivership to pay another obligation due the debtor. The decision raises no legal issue of general applicability, and review by this Court is unwarranted.

1. Petitioner contends (Pet. 6-17) that the court of appeals erred in not permitting it to confiscate Banco Credito's deposits as a setoff against the money due on the subordinated capital note. In fact, the court simply applied well known and basic principles of banking law and subordination.

The critical fact in this case is that the capital note obligation owed to petitioner was to be subordinated in all rights to the bank's depositors and other creditors. This subordination was expressly required by Puerto Rican law in Section 111(*o*) and Regulation No. 4, and was explicitly incorporated in the provisions of the note purchase agreement. Moreover, as was well known to the parties to the agreement, the subordination feature was essential to accomplish the purpose of shoring up the inadequate capitalization of the bank. See Pet. App. A15-A16.

It is therefore undisputed that petitioner had no right to collect its note obligation from the assets of the receivership before the claims of other creditors. Petitioner now seeks to avoid this limitation by means of a setoff, taking advantage of the happenstance that Banco Credito had some of its funds on deposit with petitioner. The result sought by petitioner would circumvent the subordination required by law and incorporated in the capital note agreement — to the detriment of the depositors supposedly protected by the capital note. Indeed, as the court of appeals noted (Pet. App. A19), upholding petitioner's position could open the possibility of deliberate deposits in the bank holding capital notes that would, unbeknownst to the creditors supposedly protected by the capital note, completely neutralize the subordination requirement and undermine the capitalization of the bank.

The result reached below is consistent with general principles concerning setoffs against claims asserted by receivers of an insolvent company. In *Sawyer* v. *Hoag*, 84 U.S. 610 (1873), a shareholder of an insolvent insurance company sought to set off his obligation on a note he had given to the company (in payment for stock) against his claim under an insurance policy issued to him by the company. The Court refused to permit the setoff, explaining (84 U.S. at 622):

> The debt which the appellant owed for his stock was a trust fund devoted to the payment of all creditors of the company. As soon as the company became insolvent, and this fact became known to the appellant, the right of set-off for an ordinary debt to its full amount ceased. It became a fund belonging equally in equity to all the creditors, and could not be appropriated by the debtor to the exclusive payment of his own claim.

See also *Bausman* v. *Kinnear*, 79 F. 172, 174 (9th Cir. 1897) ("The debt due to a stockholder is entitled to no preference over other debts, and he cannot require its payments by way of set-off, to the exclusion or postponement of other claims."); *Kaye* v. *Metz*, 186 Cal. 42, 198 P. 1047 (1921).

As the court of appeals noted (Pet. App. A13-A14), cases arising under former Section 63 of the National Bank Act (12 U.S.C. (1958 ed.) 63), which provided that shareholders of national banking associations could be assessed "for all contracts, debts, and engagements of such association, to the extent of the amount of their stock therein * * *," are also instructive here because of the analogy between a capital note holder and a stockholder. In *Wingate* v. *Orchard*, 75 F. 241 (9th Cir. 1896), the court rejected a shareholder's attempt to set off his deposit claim against an assessment action brought against him by the failed bank's receiver under Section 63. The court explained (75 F. at 242-243):

> Obviously, to permit a holder of stock in such a bank to offset against an assessment for the additional liability thus imposed upon him as such holder the amount of his deposits in the bank, in respect to which he is no more entitled than any other creditor, would be, in effect, to make him a preferred creditor.

Accord, *Roth* v. *Baldwin*, 74 F.2d 1003, 1004 (D.C. Cir. 1934), cert. denied, 295 U.S. 737 (1935). See also *Scott* v. *Deweese*, 181 U.S. 202, 213 (1901) (shareholder induced to purchase shares by fraud not entitled to redress at expense of creditors).

2. Petitioner relies (Pet. 8-10) on three cases permitting a setoff pursuant to Section 68 of the old Bankruptcy Act, which allowed setoffs of "mutual debts." 11 U.S.C. (1976 ed.) 108. These cases, however, are inapposite. Banks were expressly exempted from the provisions of the old Bankruptcy Act (11 U.S.C. (1976 ed.) 22), and this Court has

consistently held that the bankruptcy laws do not apply to bank liquidations. See, *e.g.*, *Merrill* v. *National Bank*, 173 U.S. 131 (1899); *Cook County National Bank* v. *United States*, 107 U.S. 445 (1883). See also *Corbin* v. *Federal Reserve Bank*, 629 F.2d 233 (2d Cir. 1980). The cases relied upon by petitioner interpreted a specific provision in the Bankruptcy Act and do not formulate a general principle applicable here. See *Rochelle* v. *United States*, 521 F.2d 844, 850 (5th Cir. 1975); *Allegaert* v. *Perot*, 466 F. Supp. 516, 518-519 (S.D.N.Y. 1978).

Moreover, as the court of appeals explained (Pet. App. A16-A17), the cases cited by petitioner did not involve the avoidance of a subordination that was critical to the original creation of the obligation. In fact, in *Sawyer* v. *Hoag*, *supra*, this Court expressly distinguished the sort of debts that could be set off under the Bankruptcy Act from a *capital* obligation intended to be devoted to securing all the creditors of a company. 84 U.S. at 622.[1]

Petitioner also contends (Pet. 10) that the decision below conflicts with *FDIC* v. *Louisiana National Bank*, 653 F.2d 927 (5th Cir. 1981). This contention is without merit.

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[1]Apparently because the court of appeals did not follow these cases, petitioner asserts (Pet. 6-8) that the court failed to follow the mandate of 12 U.S.C. 1819 and *D'Oench, Duhme & Co.* v. *FDIC*, 315 U.S. 447 (1947), to apply federal common law. The short answer to this assertion is that the court quite plainly stated that it was following *D'Oench* and applying federal law. Pet. App. A5. The court of appeals rejected the cases cited by petitioner because they were inapposite, not because federal law was inapplicable (see *id.* at A16-A17). Indeed, the court relied principally on federal authorities. Petitioner can point to no principle of federal common law inconsistent with the decision below; it surely cannot be maintained that the court was bound to ignore the subordination requirement written into the capital note agreement simply because it was required by Puerto Rican law. Moreover, the FDIC here stands in the shoes of the receiver of the failed bank, and Puerto Rican law obviously is relevant to the question of the proper distribution of the assets of a closed, insolvent Puerto Rican bank.

Although that case did involve a subordinated capital note, the issue before the court was when the default by the closed bank occurred. The court expressly stated that it would not decide whether a subordinated claim could be set off. See 653 F.2d at 930.[2]

Finally, there is no merit to petitioner's contention (Pet. 14-17) that, regardless of general setoff principles, the setoff clause in the note purchase agreement authorized it to appropriate the deposits of the Banco Credito receivership to pay its subordinated claim. The setoff provision by its terms merely preserved existing rights of setoff, which, as explained above, should not be interpreted to allow a subordinated creditor to nullify the subordination provision. Even if the provision was intended by petitioner to override the subordination provision, the court of appeals correctly concluded that the approval of the agreement by the Secretary could not operate to negate the subordination required by statute. See Pet. App. A19-A20.

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[2]Petitioner's contention (Pet. 10-12) that *Chase Manhattan Bank* v. *FDIC*, 554 F. Supp. 251 (W.D. Okla. 1983), is inconsistent with the decision below is mistaken. That case involved a setoff, but not a subordinated claim, and thus did not concern the issue presented here.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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